

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

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JTWoods

date: **MAY 13 2002**

to: [REDACTED] International Examiner (LMSB:HMT:[REDACTED])  
[REDACTED] International Team Manager (LMSB:HMT:[REDACTED])

from: Associate Area Counsel  
(Heavy Manufacturing, Construction and Transportation:Edison)

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subject: [REDACTED] **Classification and Recapture of Overall Foreign Loss**

This memorandum responds to your request for assistance dated February 26, 2002. This memorandum should not be cited as precedent. You requested advice on whether the taxpayer can amend its return to change the category of an overall foreign loss (OFL) from the general to the passive limitation category pursuant to the transitional rule of Treasury Regulation § 1.904(f)-12(a)(2)(ii).

**ISSUES**

ISSUE 1: Whether the overall foreign loss attributable to the worthlessness of the taxpayer's wholly-owned foreign subsidiary is properly allocable to the same class of income to which a hypothetical gain on the same transaction would be allocable.

ISSUE 2: Whether the overall foreign loss attributable to the worthlessness of the taxpayer's wholly-owned foreign subsidiary is properly allocable to the passive limitation category under § 904(d)(1)(A) (as amended by the Tax Reform Act of 1986).

ISSUE 3: Whether the taxpayer has met the required evidentiary burden in order to recapture the overall foreign loss associated with the worthlessness of its foreign subsidiary against the passive limitation category only, pursuant to the tracing rule of Treasury Regulation § 1.904(f)-12(a)(2)(ii).

**PROPOSED CONCLUSIONS**

ISSUE 1: The overall foreign loss is not allocable to the same class of income to which a hypothetical gain on the same transaction would be allocable. The reciprocal-to-gain rule is not applicable to the taxpayer's [REDACTED] worthless stock loss. The loss attributable to the worthlessness of the taxpayer's wholly-owned foreign subsidiary is

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properly allocable to foreign-source dividend income.

**ISSUE 2:** The taxpayer may not reallocate the overall foreign loss created by the worthlessness of the taxpayer's controlled foreign corporation to the passive limitation category. Under applicable authorities effective as of the date of the transaction, the loss would be allocable to dividend income. To determine the appropriate separate limitation category for dividend income generated by F, the taxpayer must apply the look-through rules of § 904(d)(3). F, during its existence, was a manufacturing company which generated only general limitation category income. Therefore, the loss is properly allocable to the general limitation category.

**ISSUE 3:** As a result of our findings with respect to Issues 1 and 2, the taxpayer may not, pursuant to § 1.904(f)-12(a)(2)(ii), recapture the overall foreign loss account associated with the worthlessness of its subsidiary against income in the passive limitation category only.

### FACTS

██████████ Inc. (hereinafter "Taxpayer") is a calendar year domestic corporation that at one time owned ██████% (through direct and indirect ownership) of ██████████ Ltd. (hereinafter "F"), a controlled foreign corporation domiciled in ██████. F was incorporated in ██████ and was engaged in the business of ██████ manufacturing. In ██████, Taxpayer liquidated F, and reported a worthless stock loss under § 165(g)(3). Taxpayer had an overall foreign loss ("OFL") for the ██████ tax year. Taxpayer deducted the loss against its U.S. source taxable income for the year. The loss was allocated to the general limitation category under former § 904(d)(1)(E). It appears that Taxpayer recaptured its ██████ overall foreign loss against general limitation income in the ██████-██████ tax years.

On its originally filed ██████ tax return, Taxpayer reported foreign source income allocable to the general limitation category under § 904(d)(1)(I). As required by § 904(f), Taxpayer recharacterized a portion of its ██████ foreign source income as U.S. income to the extent of the ██████ OFL account balance.

In ██████, Taxpayer amended its ██████ return. On the amended return, Taxpayer treated the ██████ loss on the worthlessness of F as a passive limitation category OFL (the taxpayer also made other adjustments which increased both foreign source and U.S. source taxable income). Therefore, because Taxpayer had no foreign source income allocated to the passive limitation category in ██████, the majority of the ██████ general OFL account was not recaptured on the amended ██████ return. As a result, the numerator of the taxpayer's overall foreign tax credit limitation amount was increased, resulting in an increase in the amount of foreign tax credit claimed. The adjustments reflected on the amended return are summarized below:

	Per originally filed [REDACTED] return	Per amended [REDACTED] return
General limitation income	\$ [REDACTED]	\$ [REDACTED]
Recapture of OFL	\$ [REDACTED]	\$ [REDACTED]
Numerator of limitation fraction	\$ [REDACTED]	\$ [REDACTED]
Denominator of limitation fraction	\$ [REDACTED]	\$ [REDACTED]
Limitation fraction	[REDACTED]	[REDACTED]
U.S. Income tax	\$ [REDACTED]	\$ [REDACTED]
Foreign tax credit	\$ [REDACTED]	\$ [REDACTED]

### LAW AND ANALYSIS

Section 904 provides mechanical rules for determining the overall limitation on the amount of foreign tax credit that can be claimed in a given tax year. Gross income and deductions must be allocated to one or more separate limitation categories enumerated in § 904(d), and the taxpayer must determine the foreign tax credit limitation amount separately for each separate category. Prior to the Tax Reform Act of 1986 (1986 Act), there were five categories as described in former Section 904(d)(1): interest, DISC dividends, foreign trade income, FSC distributions, and a general category for all other items not described in the previous four categories. The 1986 Act removed the "interest" category and created five additional specific categories of income under § 904: passive income, financial services income, high withholding tax interest, shipping income, and dividends from noncontrolled § 902 corporations. § 904(d)(1)(as amended).

Section 904(f) defines an overall foreign loss ("OFL") as the excess of foreign source deductions over foreign source income. An OFL in a particular category may be used to offset U.S. source income, but it is subject to recapture in later years. The recapture rules require that subsequent foreign source taxable income in the same category as the OFL must be recharacterized as U.S. source for purposes of the foreign tax credit limitation calculation. IRC § 904(f).

Transitional rules provide that OFLs originally allocated to the pre-1986 Act general limitation category must be recaptured in subsequent years by recharacterizing income in any of the following four post-1986 Act categories: general limitation income, financial services income, shipping income, or dividends from noncontrolled section 902 corporations. § 1.904(f)-12(a)(2)(i). However, Treas. Reg. § 1.904(f)-12(a)(2)(ii) provides an exception to the general rule:

(ii) Exception. If a taxpayer can demonstrate to the satisfaction of the district director that an overall foreign loss in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, is attributable, in sums certain, to losses in one or more separate categories of section 904(d)(1) (including for this purpose the passive income category and the high withholding tax interest category), as in effect for post-effective date taxable years, then the taxpayer may recapture the loss (in the amounts demonstrated) from those separate categories only.

The taxpayer relied on the tracing rule of Treas. Reg. § 1.904(f)-12(a)(2)(ii) as the basis for reallocating the OFL created by the loss on the worthlessness of its subsidiary from the general to the passive limitation category. The taxpayer asserts that because a gain from the sale of the stock of a controlled foreign corporation subsidiary would have been passive income within the meaning of post-1986 Act § 904(d)(2)(A), a loss from the sale should also be allocated to the passive limitation category.

The analysis of the taxpayer's claim is threefold. First, we must determine the class of income to which the worthless stock loss should be allocated. Second, we must determine the appropriate separate limitation category for the class of income to which the loss is allocated. Last, we must determine whether the taxpayer has fulfilled the evidentiary requirement of Treas. Reg. § 1.904(f)-12(a)(2)(ii).

**ISSUE 1: Whether the overall foreign loss attributable to the sale of the taxpayer's wholly-owned foreign subsidiary is properly allocable to the same class of income to which a hypothetical gain on the same transaction would be allocable.**

For purposes of determining the source of a deduction, a taxpayer must first allocate the deduction to a class of gross income. § 1.861-8(a)(2). The character of a deduction is determined not by the nature of the deduction itself, by the type of income to which it is allocated. Allocations are made on the basis of the factual relationship of deductions to gross income. § 1.861-8(a)(2).

The determination of the type of income to which the [REDACTED] OFL should be allocated should be made under the law as in effect at the time of the transaction. Prior to the 1986 Act, there was no specific statutory rule prescribing the treatment of loss from the sale of a foreign affiliate's stock. Gain from the sale of stock of a foreign affiliate was governed by the general sourcing rules applicable to all sales of personal property (former §§ 861 through 863). The regulations promulgated under former § 861 (as in effect prior to the 1986 Act) addressed the treatment of a loss on the sale or exchange of personal property. Treas. Reg. § 1.861-8(e)(7) provided that a loss from the sale of "property" should be allocated to the "class of gross income" to which the

asset normally gives rise in the hands of the taxpayer. The term "class of gross income" is defined as the gross income to which a specific deduction is definitely related, such as "gains derived from dealings in property" or "dividends". Treas. Reg. § 1.861-8(a)(3).

The Fourth Circuit held in Black & Decker v. Commissioner that because an investment in the stock of a subsidiary would ordinarily give rise to dividend income in the hands of the taxpayer, a loss on the disposition of stock was allocable to dividend income. 986 F.2d 60 (4<sup>th</sup> Circ. 1993).<sup>1</sup> In that case, the taxpayer had recognized a loss on the sale of its foreign subsidiary during its 1981 tax year. The Court relied on Treas. Reg. § 1.861-8(e)(7) in concluding that the loss was allocable to foreign-source dividend income. The Court noted that the relevant transaction was governed by the Internal Revenue Code of 1954, "although the Internal Revenue Code of 1986 now supersedes it." Black & Decker, 986 F.2d 60, 63, n.1.

Section 865, enacted as part of the 1986 Act, provided specific sourcing rules for gain from the sale of stock of foreign affiliates. § 865(f). The 1986 Act also amended §§ 861 and 862 to render those sections inapplicable to sales of property other than inventory. The taxpayer appears to have taken the position that post-1986 Act law should govern this transaction, and that the loss on the sale of stock should be allocated to the same class of gross income as a hypothetical gain on the same transaction. This theory relies on the principles of International Multifoods, 108 T.C. 579 (1997), and Treas. Reg. § 1.865-2(a)(1). We believe that neither of these authorities is applicable in the present case.

In International Multifoods, the taxpayer recognized a loss on the sale of its foreign subsidiary. The sale occurred during 1987. The Service argued that Black & Decker applied, and that the loss should be allocated to dividend income. In finding in favor of the taxpayer, the court stated that Treas. Reg. § 1.861-8(e)(7), the regulation upon which the Black & Decker decision was predicated, was no longer applicable to sales of noninventory personal property after the 1986 Act amendments to § 861. 108 T.C. at 586. The court concluded that post-1986 Act, § 865 governed the determination of source of gain on sale of a foreign affiliate's stock. *Id.* The court further determined that, pursuant to § 865, the source of a loss on the sale of a foreign affiliate's stock should mirror the source of a gain. Although § 865 did not explicitly address the treatment of losses and the regulations under § 865 had not yet been finalized, the court believed that "reciprocal-to-gain" treatment for losses was consistent with the Congressional intent behind § 865. Therefore, the court held that the taxpayer's loss was properly allocated to gain, rather than dividend income.

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<sup>1</sup>Although dividend treatment was framed as the general rule, the court noted that dividend treatment is not automatic. For example, dividend treatment might not be appropriate where a taxpayer is in the business of buying and selling companies for the purpose of amassing capital gains.

International Multifoods is distinguishable from the present case, because the loss transaction in International Multifoods occurred in 1987, subsequent to the enactment of § 865 and the amendments to § 861. The Court in International Multifoods acknowledged the importance of this fact in distinguishing (not overruling) the Black & Decker decision. International Multifoods, 108 T.C. 579 at 586.

The taxpayer's position rests on the treatment of losses under § 865 and the regulations thereunder. If applicable, these provisions would support the taxpayer's claim. However, we believe that Section 865 and the regulations thereunder are inapplicable to this transaction. Treas. Reg. § 1.865-2(a)(1) provides in relevant part:

(a) General rules for allocation of loss with respect to stock -- (1) Allocation against gain. Except as otherwise provided in paragraph (b) of this section, loss recognized with respect to stock shall be allocated to the class of gross income and, if necessary, apportioned between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income, with respect to which gain (other than gain treated as a dividend under section 964(e)(1) or 1248) from a sale of such stock would give rise in the hands of the seller (without regard to section 865(f)). . . .

A deduction for worthlessness under § 165(g)(3) is a "loss recognized with respect to stock" subject to Treas. Reg. § 1.865-2(a)(1). T.D. 8805. Thus, although the worthlessness of F results in an ordinary loss under § 165(g)(3), under Treas. Reg. § 1.865-2(a)(1) the loss is allocable to the same class of income to which gain from a sale of F's stock would have been allocable, i.e. capital gain. Consequently, the taxpayer asserts, Taxpayer's [REDACTED] OFL should be entirely allocated to capital gain income.

The taxpayer's loss was recognized prior to enactment of § 865 and prior to the effective date of Treas. Reg. § 1.865-2(a)(1). Taxpayer's loss was recognized in [REDACTED] and was therefore subject to the Internal Revenue Code of 1954 as in effect on the date of the transaction. Treas. Reg. § 1.865-2(a)(1) is effective for loss recognized on or after January 11, 1999. A taxpayer could elect to retroactively apply the rules of this section, but only to losses occurring in any tax year beginning on or after January 1, 1987 and all subsequent years. Treas. Reg. § 1.865-2(e)(2). Therefore, by its terms, Treas. Reg. § 1.865-2(a)(1) does not apply to Taxpayer's [REDACTED] loss.

Treas. Reg. § 1.904(f)-12(a)(2)(ii) provides that a taxpayer may trace its pre-1986 Act OFL to the § 904(d) categories as in effect after the 1986 Act. The taxpayer appears to interpret this tracing rule to cause the reciprocal-to-gain rule of International Multifoods and Treas. Reg. § 1.865-2(a)(1) to apply to its pre-1986 Act transaction. The reciprocal-to-gain rule would only apply to Taxpayer's [REDACTED] transaction if we

interpret § 1.904(f)-12(a)(2)(ii) to require that the pre-1986 Act OFL be treated as if it occurred post-1986 Act, or that post-1986 Act law (beyond the mere inclusion of the new categories under § 904(d)) must be applied retroactively to transactions occurring in pre-1986 Act years.

We do not believe that § 1.904(f)-12(a)(2)(ii) should operate to make § 865 apply to a transaction which occurred prior to the statute's enactment. Given the general rule that a regulation promulgated under a statute "does not, and could not, alter the statute"<sup>2</sup>, it seems clear that a regulation promulgated under § 904 should not alter the effective date of § 865. Similarly, International Multifoods should not be given retroactive effect to the taxpayer's pre-1986 Act transaction, because that decision was predicated on the application of § 865. Moreover, as discussed in greater detail below, we believe that applying post-1986 Act law to allocate Taxpayer's pre-1986 Act OFL to a different class of income for recapture purposes would contravene the matching concept of the OFL recapture rules and the transition rules of Treas. Reg. § 1.904(f)-12(a)(2). Therefore, we believe that the taxpayer's interpretation is beyond the scope of the regulatory language and the intent of the drafters.

**ISSUE 2: Whether the overall foreign loss attributable to the worthlessness of the taxpayer's wholly-owned foreign subsidiary is properly allocable to the passive limitation category under § 904(d)(1)(A) (as amended by the Tax Reform Act of 1986).**

The taxpayer relies on the principles of Treas. Reg. § 1.865-2 (the reciprocal-to-gain rule) in allocating the worthless stock loss to the same class of income to which a hypothetical gain on the sale of the stock would have been allocated (i.e. capital gain). As a consequence, the taxpayer allocates the OFL generated on the disposition to the same separate limitation category under § 904 to which such hypothetical gain would have been assigned. § 1.865-2(a)(1).

Passive income is defined generally for purposes of § 904(d)(2)(A) as "income that is of a kind that would be foreign personal holding company income (as defined in section 954(c)) if the taxpayer were a controlled foreign corporation, including any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248." Treas. Reg. § 1.904-4(b)(1)(i)(A).<sup>3</sup> Because a gain on the sale of F stock would have been allocable to the passive limitation category, the taxpayer reasons, the OFL created by the worthless stock loss should be allocated to

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<sup>2</sup>Manhattan General Equipment Co. v. Commissioner, 297 US 129 (1936).

<sup>3</sup>Because the subsidiary is assumed to have no current or accumulated earnings and profits at the time of the disposition, the application of § 1248 is not addressed.

the passive limitation category as well.

If F had in fact been liquidated in a tax year governed by Treas. Reg. § 1.865-2, the resulting loss would have been allocable to capital gain income, and the associated OFL would have been allocable to the passive limitation category. However, we do not believe that Treas. Reg. § 1.865-2 governs the class of income or separate limitation category determinations for Taxpayer's loss because the regulation was not yet effective when the loss was recognized. We also do not construe Treasury Regulation § 1.904(f)-12(a)(2)(ii) to cause Treas. Reg. § 1.865-2 to apply. The relevant authorities applicable to the class of income determination for a [REDACTED] transaction are Black & Decker and Treas. Reg. § 1.861-8(e)(7). Pursuant to these authorities, the taxpayer's worthless stock loss is allocable to dividend income. Therefore, in order to determine the appropriate separate limitation category for the OFL, we must look to the rules applicable to dividends from controlled foreign corporations.

Passive income does not include any income that would otherwise be passive but is characterized as income in another separate category under the look-through rules of § 1.904-5. Treas. Reg. § 1.904-4(b)(1)(i)(B). The look-through rules provide that, in general, dividends received or accrued from a CFC in which the taxpayer is a U.S. shareholder "shall be treated as general limitation income". § 1.904-5(b). Dividends paid from the earnings and profits of a CFC should be allocated to the category or categories of income to which the earnings and profits of the corporation are allocable. § 1.904-5(c)(4). The taxpayer has stated that to the best of their knowledge F had no current or accumulated earnings and profits at the time it was liquidated. However, F was a manufacturing company which had generated earnings and profits allocable only to the general limitation category. Therefore, a dividend paid from F would be treated as general limitation category income under the look-through rule of Treas. Reg. § 1.904-5(c)(4). Because dividend income from F would have been allocable to the general limitation category, the loss recognized with respect to the F stock is also allocable to the general limitation category.

The taxpayer might argue that § 1.904(f)-12(a)(2)(ii) permits the taxpayer to recapture its pre-1986 Act OFL out of a class of income that the OFL was not allowed to offset under pre-1986 Act law, but would have been allowed to offset had the original loss occurred post-1986 Act. However, the preamble to Treas. Reg. § 1.904(f)-12(a)(2)(ii) indicates that the Service did not intend for this transition rule to change the characterization of the pre-1986 Act income with which an OFL is associated for purposes of applying the recapture rules.

If the taxpayer cannot "trace" its pre-1986 Act OFL to a specific post-1986 Act separate limitation category, the general transition rule of Treas. Reg. § 1.904(f)-12(a)(2)(i) applies. The general transition rule requires that OFLs originally allocated to the pre-1986 Act general limitation category must be recaptured in subsequent years by



recharacterizing post-1986 Act income in any of the following four post-1986 Act categories: general limitation income, financial services income, shipping income, or dividends from noncontrolled section 902 corporations. In reference to public comments regarding the proposed rule, T.D. 8306, 55 FR 31380, states:

"Commentors asserted that this rule unfairly limits recapture of a pre-effective date general limitation overall foreign loss from post-effective date passive income or high withholding tax interest. They state that the rule is unfair because passive income and high withholding tax interest income may have been included in general limitation income in pre-effective date years. Accordingly, the commentors contend, taxpayers should be permitted to recapture pre-effective date general limitation overall foreign losses from post-effective date passive income and high withholding tax interest income as well as from general limitation income, financial services income, shipping income and dividends from each noncontrolled section 902 corporation.

"This suggestion was rejected because post-effective date passive income and high withholding tax interest income could include substantial amounts of income that would have been separate limitation interest in pre-effective date years. Thus, a general rule that permitted taxpayers to recapture pre-effective date overall foreign losses out of post-effective date passive income or high withholding tax interest income likely would result in taxpayers recapturing those losses out of income that the loss would not have been allowed to offset if the income had been earned in a pre-effective date year." [emphasis added]

The OFL recapture rules were designed to prevent taxpayers from obtaining a double benefit under the foreign tax credit provisions by first reducing worldwide income in the loss year, and then by escaping U.S. tax on subsequent income in the same category through use of foreign tax credits. To that end, the recapture rule endeavors to match OFLs with the type of subsequent income that the loss would have offset had the income been earned in the year of the loss. Similarly, the transition rules of Treas. Reg. § 1.904(f)-12(a)(2) are designed to ensure that pre-1986 Act losses are recaptured out of the type of post-1986 Act income that the loss would have been allowed to offset if the income had been earned in a pre-1986 Act year.

In [REDACTED] the taxpayer's loss was required to be allocated to dividend income under then existing law. The OFL associated with the worthless stock loss must be recaptured only out of the same type of income that the loss originally offset, i.e. dividend income. In this case, the dividend income to which the loss was allocated would be general limitation income under post-1986 Act § 904(d). The associated overall foreign loss cannot, therefore, be recaptured only out of passive income in post-1986 Act years. Recapturing the OFL out of passive income would result in the situation that the drafters sought to avoid, i.e. "recapturing those losses out of income

that the loss would not have been allowed to offset if the income had been earned in a pre-effective date year".

In sum, Treas. Reg. § 1.904(f)-12(a)(2)(ii) does not change the type of income to which a pre-1986 Act OFL was allocated under the sourcing rules of former § 861. It merely changes the available categories to which income of the same type as the income which the OFL originally offset can be assigned in determining the category of the OFL. Thus, the taxpayer's OFL retains its original association with the dividend income it offset in [REDACTED] and must be recaptured out of the same category to which such dividend income would have been assigned under the post-1986 Act categories of § 904(d). The CFC dividend income to which the taxpayer's OFL was originally assigned would be allocable to the general limitation category under post-1986 Act § 904(d). Therefore, the taxpayer's [REDACTED] OFL must be recaptured out of general limitation category income.

**ISSUE 3: Whether the taxpayer has met the required evidentiary burden in order to recapture the overall foreign loss associated with the worthlessness of its foreign subsidiary against the passive limitation category only, pursuant to the tracing rule of Treasury Regulation § 1.904(f)-12(a)(2)(ii).**

In order to take advantage of the tracing rule of Treasury Regulation § 1.904(f)-12(a)(2)(ii), the taxpayer must demonstrate to the satisfaction of the district director that an overall foreign loss in the general limitation category of pre-1986 Act § 904(d)(1)(E), is attributable, "in sums certain", to one of the post-1986 Act categories of § 904(d)(1)(A)-(I). Treasury Regulation § 1.904(f)-12(a)(2)(ii) places the burden on Taxpayer to demonstrate that a specific amount of the overall foreign loss associated with the worthlessness of its foreign subsidiary is attributable to the passive limitation category. In light of the facts and circumstances surrounding the loss and the conclusions reached with respect to Issues 1 and 2, the taxpayer cannot make such a demonstration regarding its [REDACTED] worthless stock deduction.

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If you have any questions or require further information, please call attorney Jadie Woods at (313) 237-6434.

#### DISCLOSURE STATEMENT

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Phoebe Nearing  
Associate Area Counsel  
(Large and Mid-Size Business)

By: /s/  
JADIE T. WOODS  
Attorney (LMSB)